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A DESCRIPTION OF CALIFORNIA TAX CREDIT ALLOCATION COMMITTEE PROGRAMS

The California Tax Credit Allocation Committee ("Committee" or "TCAC") administers two low-income housing tax credit programs -- a federal program and a state program. Both programs were authorized to encourage private investment in rental housing for low -and lower-income families and individuals.

The Committee

The Committee has seven members, three voting members and four advisors. The voting members include the State Treasurer, who serves as chairman, the State Controller, and the Governor. At the Governor's discretion, either the Governor or the Director of the Department of Finance may serve on the Committee.

The non-voting advisors are the Executive Director of the California Housing Finance Agency, the Director of the Department of Housing and Community Development, and two representatives from local government. One local representative must be associated with a city and is appointed by the Speaker of the Assembly. The other member is a county representative appointed by the Senate Rules Committee.

The Federal Low Income Housing Tax Credit Program

Congress authorized the federal program ("Credit program") in 1986. It replaced traditional housing tax incentives, such as accelerated depreciation, with a tax credit that enables developers of affordable rental housing to raise project equity through the "sale" of tax benefits to investors.

The Credit program is contained in the federal tax code and is administered by the Internal Revenue Service, which is part of the U.S. Treasury Department. Section 42 of the Internal Revenue Code specifies that, in each state, the state legislature designates the "housing credit agency" to administer the Credit program. In California, responsibility for administering the program was assigned to the California Tax Credit Allocation Committee, first by a February 1987 gubernatorial proclamation, and later by enactment of SB 113, Chapter 658, Statutes of 1987. The federal tax credit was granted permanent status with passage of the Omnibus Budget Reconciliation Act of 1993.

The State Program

Recognizing the high cost of developing housing in California, the legislature authorized a state low income housing tax credit program to augment the federal tax credit program. Authorized by Chapter 1138, Statutes of 1987, the state credit is only available to a project which has previously received, or is concurrently receiving, an allocation of federal credits. The state program does not stand alone, but instead, supplements the federal tax credit program.

Annual Competitive ("9%") Federal Credits Available

For 2003, each state has an annual housing credit ceiling of $1.75 per state resident, and may qualify for a prorata share of credits available annually in a national pool comprised of states' unused credits. Beginning January 1, 2004, and thereafter, this amount will be indexed for inflation. Also, credits returned from a credit recipient can be allocated to new projects. From the total ceiling amount available to California, the Committee allocates credit based upon assessments of eligible project costs, as defined by IRC Section 42. The housing sponsor has available ten times the allocation amount, since investors can take the annual credit each year for a ten-year period. Although the credit is taken over a ten-year period, the Internal Revenue Code requires that the project remain in compliance for a minimum of 15 years.

Annual State Credits Available

The annual state credit ceiling is currently $70 million, indexed for inflation (in addition to any unused or returned credits from previous years).

Investors take the state credit over a four-year period in contrast to the ten-year federal allocation period. The full four-year state credit allocated to a project is deducted from the annual state credit ceiling, while only the annual federal credit allocated to a project is deducted from the federal ceiling.

Tax-Exempt Bond Financed Program

Developments that are financed with the proceeds of tax-exempt bonds may also receive federal tax credit. In this instance, the developer/owner of a tax-exempt development must apply to the Committee and must conform to the federal and state statutory and regulatory requirements, but there is no annual "cap" on the amount of credit that may be awarded by the state to such developments. The credit available is based on approximately 4% (instead of 9%) of the "qualified basis" of the development, that is, the costs attributable to the units that will be income and rent restricted for a minimum of 30 years.

Eligible Projects

Only rental housing projects are eligible for tax credits in both the federal and state programs. Credits can be allocated to new construction projects or for the acquisition and rehabilitation of certain projects. Except for developments financed with proceeds of tax-exempt bonds, credits are allocated on a competitive basis so that those meeting the highest housing priorities and public policy objectives, as determined by the Committee, have first access to credits. Those utilizing tax credits must have an ownership interest in the project for which the credits are awarded. Tax credits are allocated based on the cost basis of the project, including hard and soft development costs associated with building the project. Land costs cannot be included in determining the amount of credits needed.

Rent and Income Restrictions

The Credit program has both rent and income restrictions. Rents on tax credit units cannot exceed 30% of an imputed income based on 1.5 persons per bedroom (i.e., in a two-bedroom unit, the income of a three-person household is used to calculate rent, regardless of the actual family size of the household).

Federal Law requires that the initial incomes of households in tax credit units cannot exceed either 60% or 50% of the area median income, adjusted for household size. When a project developer or sponsor is allocated tax credits, he or she irrevocably elects one of the following minimum federal set-aside requirements:

- a minimum of 40% of the units must be both rent-restricted and occupied by households whose incomes are 60% or less of the area median gross income, adjusted for family size, or

- 20% of the units must be both rent-restricted and occupied by households whose incomes are 50% or less of the area median gross income, adjusted for family size.

Despite this minimum set-aside election, project sponsors typically designate all of the units in a project for occupancy by low-income households, since credits are allocated only for restricted units. For instance, if a developer builds a project in which half of the units are market-rate and half are affordable, only half of the eligible project costs would be considered when determining how much credit may be allocated. Additionally, as described later, sponsors generally target units to tenants with incomes below 60% or 50% of median to compete successfully in this highly competitive allocation process.

Long Term Affordability

Under federal law, credit projects must remain affordable for at least 15 years; however, California's program generally requires maintaining affordability for 55 years. Land use agreements are recorded against each credit project to ensure compliance.

Determination of Credit Need

As required by federal law, the Committee performs feasibility analyses on every project to ensure that allocations do not exceed the amount required for project feasibility. While a project's qualified basis determines a maximum credit allocation, only the amount needed to fill the financing shortfall can actually be allocated. The Committee must consider the sources and uses of funds and the total financing planned for the development, including the projected proceeds to be generated by the tax credits. The Committee must also determine the reasonableness of estimated development, operational and intermediary costs. For each project, the amount of credit needed must be determined at least three times: at application, allocation, and placed-in-service.

How Credit Amounts Are Calculated

As required by federal law, the maximum credit amount that may be allocated to a project is based on the project's qualified basis. First, total project cost is calculated. Secondly, eligible basis is determined by subtracting non-depreciable costs, such as land, permanent financing costs, rent reserves and marketing costs. The project developer may also voluntarily reduce the requested eligible basis in order to gain a competitive advantage. If the development is located in a HUD designated high cost area (HCA), the eligible basis receives a 130% adjustment. Finally, to determine the qualified basis, the eligible basis is multiplied by the applicable fraction, which is the smaller of the percentage of low income units to total units or the percentage of square footage of the low income units to the square footage of the total units, to arrive at the qualified basis.

The qualified basis is multiplied by the federal tax credit rate, published monthly by the IRS, to determine the maximum allowable tax credit allocation. For new construction or rehabilitation projects that are not financed with a federal subsidy, the rate is approximately 9%. For projects involving a federal subsidy (including projects financed more than 50% with tax exempt bonds), the rate is approximately 4%. Due to the fluctuating federal tax credit rate published monthly by the IRS, TCAC uses an 8.1% and 3.5% rate to determine a project's initial tax credit reservation. A project's final (placed-in-service) tax credit allocation is based on actual project sources and uses of funds, the financing shortfall and the actual applicable federal rate. The rate applicable to a project is the rate published for the month each building is placed in service or in an earlier month elected by the sponsor. The allocation cannot exceed the initial reservation amount and may be reduced if an analysis determines that the maximum allowable amount would generate excess equity proceeds to the project.

Raising Equity Investment

Most credits are “sold” to corporate investors through public or private syndication. Investors benefit from the tax credit by purchasing an ownership interest in one or more tax credit housing projects. In turn, investors take a dollar-for-dollar credit against their tax liability over a ten-year period. Partnership equity contributed to the project in exchange for the credit typically finances 30-60% of the capital costs of project construction.

The net amount of equity proceeds contributed to a project is based on investor contributions (the present value of the ten-year credit) less syndicator overhead and fees and other syndication-related costs. The Committee uses the net tax credit factor (net proceeds divided by the total 10-year tax credit allocation) to determine the credit amount needed.

Differences Between the State and Federal Programs

California's tax credit program was structured to mirror the federal program with certain exceptions. In addition to the state credit only being available to projects that also receive a federal credit, other major differences include:

- TCAC gives priority for state credit allocations to projects not located in a designated high cost area and those using HOME funds to finance eligible costs.

- The applicable percentage to be applied to the qualified basis for determining the amount of state credits is 30% for projects which are not federally subsidized, and 13% for projects which are federally subsidized, in contrast to 9% and 4% for the federal credit.

- State credits are not available for acquisition costs, except for already assisted projects that qualify as "at-risk" of being converted to market rate.

- The state program has a rate of return limitation. Any surplus revenues generated above the limitation must be used to reduce rents.

Federal Preference and Selection Criteria

Each state agency is responsible for designing and implementing its housing tax credit program in accordance with requirements of the Internal Revenue Code and its own particular state housing needs. The Internal Revenue Code sets broad parameters that must be considered by each state in its "Qualified Allocation Plan" (QAP), adopted after public hearings and input, that sets forth the state's program.

Section 42, for example, requires that each state give preference to projects that serve the lowest income tenants, projects that are obligated to serve qualified low income tenants for the longest period of time, and projects that are located in qualified census tracts that contribute to a concerted community revitalization plan.

Additionally, the following selection criteria must be considered by each state in awarding credit: project location, housing needs characteristics, project characteristics, tenant populations with special housing needs, public housing waiting lists, tenant populations of individuals with children, and projects intended for eventual tenant ownership.

California's Program

In California, the demand for housing tax credit has traditionally exceeded the supply by approximately 3 to 1. This means, of course, that many good, worthwhile projects are unable to be awarded credit. It also means that a rather elaborate set of legal and regulatory rules for determining what projects are awarded credit has been established. State and federal law require that at least 10% of the annual credit be awarded to projects that materially involve non-profits. State law also requires that 20% of the annual credit be awarded to projects located in rural areas of the state, and that 2% of the credit be set-aside for small projects of 20 or fewer units. Additionally, to assure geographic distribution of the tax credit, a certain percentage of credit is awarded each year to projects located in twelve geographic regions of the state.

Public policies encouraging smart growth principles, energy efficiencies, and the like are part of California's housing tax credit program. In its competitive scoring system, points are awarded for a variety of items, ranging from serving lower income tenants, to achieving energy efficiencies, to the degree that the project will contribute to revitalization efforts in the area where it will be located.

Threshold criteria require that the applicant show the following:

(a) the type of housing proposed is needed and affordable to the targeted population within the community in which it is to be located;
(c) enforceable financing commitments of at least 50% of the total estimated financing need;
(d) control of the site;
(e) compliance with all applicable local land use and zoning ordinances;
(f) development team experience and financial capacity to ensure project completion and operation for the extended use period;
(g) financial viability throughout the compliance period of the project;
(h) minimum construction standards;

(i) deferred-payment financing, grants, and subsidies be "committed" at application; and
(j) generally with the exception of tax-exempt bond projects, project size is limited to no more than 200 units for non-rural set-aside applications, and 80 units for rural set-aside applications. (Beginning in July, 2003, these numbers were reduced to 150 and 60, respectively for new applications.)

In addition, targeted projects must meet additional threshold requirements applicable to the targeted populations they intend to serve. These additional threshold requirements can be found in the Regulations.

Application Cycles and TCAC Review Process

Generally, the Committee holds two application cycles each year, unless circumstances warrant a reduction in the number of cycles. The first cycle is generally held in March, with a second cycle following in July. Awards are usually made in late May and late September.

Application Process

TCAC has prepared an application package that is intended to assist applicants present clearly the characteristics of their project. Staff reviews the application to determine the reasonableness of project costs, the maximum allowable tax credit allocation, and the amount of credit needed for financial feasibility.

Stages of Tax Credit Reservation

Federal law has stringent requirements for making allocations and placing projects in service. A slip in timing could cause credit to be lost. For this reason, the Committee has established progress requirements for all tax credit recipients.

(1) Preliminary Reservation - Generally, when applications are submitted to TCAC, projects are not yet ready to begin construction and the applicant seeks a Preliminary Reservation.

(2) Final Reservation - Project sponsors receive a Final Reservation when all conditions of the Preliminary Reservation have been met. The construction loan must be funded, permanent financing and any other financing required to complete the project must be committed, and a partnership agreement must be executed. A second feasibility analysis is completed. This reservation is in effect during the project's construction period.

(3) Carryover Allocation - An applicant may obtain a Carryover Allocation prior to or after a Final Reservation, depending upon the time constraints imposed by federal law. Federal law requires that a Carryover Allocation be obtained if a project will not be placed-in-service in the same year the project receives a reservation. Once a Carryover Allocation is made, project owners have until December 31 of the 2nd calendar year after the year in which the Carryover Allocation is made to place the project in service.

(4) Issuance of Tax Forms - When conditions of the Final Reservation have been met, the project is "placed in service", or ready for occupancy, the owner submits various documentation to TCAC for

review. TCAC issues IRS Forms 8609 (and the state Form FTB 3521A, if applicable) after performing a final feasibility and cost reasonableness analysis to determine the requisite amount of tax credits needed. The final analysis is based on an audited cost certification prepared by the owner's accountant. One tax form will be issued for each residential building in a project.

Before the tax forms are issued, the applicant must enter into a regulatory agreement with TCAC. This agreement is recorded against the land and holds the project owner to the specifications and characteristics of the project on which the tax credit reservation was awarded (rent and income restrictions, selection criteria, preference points and other requirements).

Compliance Monitoring

The Committee administers a compliance monitoring program involving all projects with an allocation of federal or state housing tax credits. Projects are monitored according to the requirements of Section 42, IRS regulations, and the terms of the regulatory agreement entered into between the owner and the Committee. Each project will have a site visit from TCAC staff or its agent every three years. During this visit, tenant files and rent rolls will be examined to assure that the incomes and rents are properly restricted. Other items to be inspected include promised amenities as well as the physical conditions of the development and its units.

The Commercial Revitalization Deduction Program

AB 2010, signed into law in September, 2002, designates the California Tax Credit Allocation Committee as California's Commercial Revitalization agency for the purpose of allocating federally authorized Commercial Revitalization deductions to qualified businesses located in California's five federally designated Renewal Communities. The five communities include the rural communities of Orange Cove and Parlier, and certain census tracts in the cities of Los Angeles, San Diego, and San Francisco.

The deduction is available to businesses located the these Renewal Communities that purchase, build, or renovate property for commercial use. It must be allocated by the Committee, pursuant to a Qualified Allocation Plan that the Committee has adopted, and can be claimed, once allocated, at the taxpayer's election, either in the amount of 50% of the qualified costs in the first year after the building is placed in service, or at the rate of 10% per year for 10 years, beginning in the year the building is placed in service. A total of $12 million in deductions is available to each Renewal Community for each year beginning in 2002 and ending in 2009. In 2003, the Committee allocated a total of $5.9 million in deductions to 3 such projects.